

LSI INDUSTRIES INC
Form 10-Q
January 30, 2009

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

X QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD
ENDED DECEMBER 31, 2008.

____ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD
FROM _____ TO _____.

Commission File No. 0-13375

LSI Industries Inc.

State of Incorporation - Ohio IRS Employer I.D. No. 31-0888951

10000 Alliance Road

Cincinnati, Ohio 45242

(513) 793-3200

Indicate by checkmark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days. YES NO

Indicate by checkmark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer [] Accelerated filer []

Non-accelerated filer [] Smaller reporting company
[]

Indicate by checkmark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of January 23, 2009 there were 21,570,299 shares of the Registrant's common stock outstanding.

LSI INDUSTRIES INC.
FORM 10-Q
FOR THE QUARTER ENDED DECEMBER 31, 2008

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“Safe Harbor” Statement under the Private Securities Litigation Reform Act of 1995

This Form 10-Q contains certain forward-looking statements that are subject to numerous assumptions, risks or uncertainties. The Private Securities Litigation Reform Act of 1995 provides a safe harbor for forward-looking statements. Forward-looking statements may be identified by words such as “estimates,” “anticipates,” “projects,” “plans,” “expects,” “intends,” “believes,” “seeks,” “may,” “will,” “should” or the negative versions of those words and similar expressions and by the context in which they are used. Such statements, whether expressed or implied, are based upon current expectations of the Company and speak only as of the date made. Actual results could differ materially from those contained in or implied by such forward-looking statements as a result of a variety of risks and uncertainties. These risks and uncertainties include, but are not limited to, the impact of competitive products and services, product

demand and market acceptance risks, reliance on key customers, financial difficulties experienced by customers, the adequacy of reserves and allowances for doubtful accounts, fluctuations in operating results or costs, unexpected difficulties in integrating acquired businesses, the ability to retain key employees of acquired businesses and the other risk factors that are identified herein. In addition to the factors described in this paragraph, the risk factors identified in our Form 10-K constitute risks and uncertainties that may affect the financial performance of the Company. The Company has no obligation to update any forward-looking statements to reflect subsequent events or circumstances.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

LSI INDUSTRIES INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(Unaudited)

| (in thousands, except per share data) | Three Months Ended December 31 | | Six Months Ended December 31 | |
|---|-----------------------------------|----------|---------------------------------|-----------|
| | 2008 | 2007 | 2008 | 2007 |
| Net sales | 60,787 | 84,062 | 136,625 | 174,063 |
| Cost of products and services sold | 47,530 | 60,603 | 105,189 | 124,853 |
| Gross profit | 13,257 | 23,459 | 31,436 | 49,210 |
| Selling and administrative expenses | 14,014 | 15,750 | 27,977 | 30,775 |
| Goodwill impairment | 12,669 | -- | 12,669 | -- |
| Operating income (loss) | (13,426) | 7,709 | (9,210) | 18,435 |
| Interest (income) | (45) | (98) | (83) | (250) |
| Interest expense | 44 | 18 | 87 | 38 |
| Income (loss) before income taxes | (13,425) | 7,789 | (9,214) | 18,647 |
| Income tax expense (credit) | (363) | 2,966 | 1,161 | 6,871 |
| Net income (loss) | \$ (13,062) | \$ 4,823 | \$ (10,375) | \$ 11,776 |
| Earnings (loss) per common share (see Note 5) | | | | |
| Basic | \$ (0.60) | \$ 0.22 | \$ (0.48) | \$ 0.54 |
| Diluted | \$ (0.60) | \$ 0.22 | \$ (0.48) | \$ 0.53 |
| Weighted average common shares outstanding | | | | |
| Basic | 21,799 | 21,759 | 21,798 | 21,737 |
| Diluted | 21,799 | 22,063 | 21,798 | 22,036 |

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these financial statements.

LSI INDUSTRIES INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

| (In thousands, except share amounts) | December 31, 2008 | June 30, 2008 |
|--|-------------------------|-------------------|
| ASSETS | | |
| Current Assets | | |
| Cash and cash equivalents | \$ 8,227 | \$ 6,992 |
| Accounts receivable, net | 35,221 | 38,857 |
| Inventories | 43,918 | 50,509 |
| Refundable income taxes | 167 | 1,834 |
| Other current assets | 5,817 | 6,111 |
| Total current assets | 93,350 | 104,303 |
| Property, Plant and Equipment, net | 42,704 | 44,754 |
| Goodwill, net | 2,382 | 15,051 |
| Other Intangible Assets, net | 14,021 | 15,060 |
| Other Assets, net | 4,810 | 4,372 |
| TOTAL ASSETS | \$ 157,267 | \$ 183,540 |
| LIABILITIES & SHAREHOLDERS' EQUITY | | |
| Current Liabilities | | |
| Accounts payable | \$ 10,675 | \$ 15,452 |
| Accrued expenses | 9,098 | 15,988 |
| Total current liabilities | 19,773 | 31,440 |
| Long-Term Debt | -- | -- |
| Other Long-Term Liabilities | 3,087 | 3,584 |
| Shareholders' Equity | | |
| Preferred shares, without par value; Authorized 1,000,000 shares; none issued | -- | -- |
| Common shares, without par value; Authorized 30,000,000 shares; Outstanding 21,569,894 and 21,585,390 shares, respectively | 82,245 | 81,665 |
| Retained earnings | 52,162 | 66,851 |
| Total shareholders' equity | 134,407 | 148,516 |
| TOTAL LIABILITIES & SHAREHOLDERS' EQUITY | \$ 157,267 | \$ 183,540 |

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these financial statements.

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LSI INDUSTRIES INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

| (In thousands) | Six Months Ended December 31 | |
|---|---------------------------------|-----------|
| | 2008 | 2007 |
| Cash Flows from Operating Activities | | |
| Net income (loss) | \$ (10,375) | \$ 11,776 |
| Non-cash items included in net income | | |
| Depreciation and amortization | 3,976 | 4,471 |
| Goodwill impairment | 12,669 | -- |
| Deferred income taxes | (261) | 49 |
| Deferred compensation plan | 76 | 97 |
| Stock option expense | 645 | 599 |
| Issuance of common shares as compensation | 20 | 20 |
| Loss on disposition of fixed assets | 1 | -- |
| Allowance for doubtful accounts | 234 | 92 |
| Inventory obsolescence reserve | 220 | 176 |
| Changes in | | |
| Accounts receivable, gross | 3,402 | 12,863 |
| Inventories, gross | 6,371 | (1,190) |
| Accounts payable and other | (9,443) | (7,627) |
| Reserve for uncertain tax positions charged against retained earnings | -- | (2,582) |
| Customer prepayments | (937) | (11,430) |
| Net cash flows from operating activities | 6,598 | 7,314 |
| Cash Flows from Investing Activities | | |
| Purchases of property, plant and equipment | (888) | (2,543) |
| Proceeds from sale of fixed assets | -- | 1 |
| Proceeds from sale of short-term investments | -- | 8,000 |
| Net cash flows from (used in) investing activities | (888) | 5,458 |
| Cash Flows from Financing Activities | | |
| Payment of long-term debt | (1,282) | (958) |
| Proceeds from issuance of long-term debt | 1,282 | 958 |
| Cash dividends paid | (4,314) | (7,107) |
| Exercise of stock options | -- | 848 |
| Purchase of treasury shares | (161) | (215) |
| Issuance of treasury shares | -- | 28 |
| Net cash flows (used in) financing activities | (4,475) | (6,446) |
| Increase in cash and cash equivalents | 1,235 | 6,326 |
| Cash and cash equivalents at beginning of year | 6,992 | 2,731 |

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| | | | | |
|--|----|-------|----|-------|
| Cash and cash equivalents at end of period | \$ | 8,227 | \$ | 9,057 |
| Supplemental Cash Flow Information | | | | |
| Interest paid | \$ | 56 | \$ | 39 |
| Income taxes paid | \$ | 346 | \$ | 9,087 |
| Issuance of common shares as compensation | \$ | 20 | \$ | 20 |

The accompanying Notes to Condensed Consolidated Financial Statements are an integral part of these financial statements.

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LSI INDUSTRIES INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1: INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The interim condensed consolidated financial statements are unaudited and are prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information, and rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. In the opinion of Management, the interim financial statements include all normal adjustments and disclosures necessary to present fairly the Company's financial position as of December 31, 2008, and the results of its operations for the periods ended December 31, 2008 and 2007, and its cash flows for the periods ended December 31, 2008 and 2007. These statements should be read in conjunction with the financial statements and footnotes included in the fiscal 2008 annual report. Financial information as of June 30, 2008 has been derived from the Company's audited consolidated financial statements.

NOTE 2: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Consolidation:

The consolidated financial statements include the accounts of LSI Industries Inc. (an Ohio corporation) and its subsidiaries, all of which are wholly owned. All intercompany transactions and balances have been eliminated.

Revenue Recognition:

The Company recognizes revenue in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 104, "Revenue Recognition." Revenue is recognized when title to goods and risk of loss have passed to the customer, there is persuasive evidence of a purchase arrangement, delivery has occurred or services have been rendered, and collectibility is reasonably assured. Revenue is typically recognized at time of shipment. Sales are recorded net of estimated returns, rebates and discounts. Amounts received from customers prior to the recognition of revenue are accounted for as customer pre-payments and are included in accrued expenses. Revenue is recognized in accordance with Emerging Issues Task Force (EITF) 00-21, "Revenue Arrangements with Multiple Deliverables," or AICPA Statement of Position 97-2 (SOP 97-2), "Software Revenue Recognition," as appropriate.

The Company has four sources of revenue: revenue from product sales; revenue from installation of products; service revenue generated from providing integrated design, project and construction management, site engineering and site permitting; and revenue from shipping and handling.

Product revenue is recognized on product-only orders at the time of shipment. Product revenue related to orders where the customer requires the Company to install the product is generally recognized when the product is installed. In some situations, product revenue is recognized when the product is shipped, before it is installed, because by agreement the customer has taken title to and risk of ownership for the product before installation has been completed. Other than normal product warranties or the possibility of installation or post-shipment service, support and maintenance of certain solid state LED video screens, billboards, or active digital signage, the Company has no post-shipment responsibilities.

Installation revenue is recognized when the products have been fully installed. The Company is not always responsible for installation of products it sells and has no post-installation responsibilities, other than normal warranties.

Service revenue from integrated design, project and construction management, and site permitting is recognized at the completion of the contract with the customer. With larger customer contracts involving multiple sites, the customer may require progress billings for completion of identifiable, time-phased elements of the work, in which case revenue is recognized at the time of the progress billing, which coincides with the completion of the earnings process. Post-shipment service and maintenance revenue, if applicable, related to solid state LED video screens or billboards is recognized according to terms defined in each individual service agreement and in accordance with generally accepted accounting principles.

Shipping and handling revenue coincides with the recognition of revenue from sale of the product.

Credit and Collections:

The Company maintains allowances for doubtful accounts receivable for probable estimated losses resulting from either customer disputes or the inability of its customers to make required payments. If the financial condition of the Company's customers were to deteriorate, resulting in their inability to make the required payments, the Company may be required to record additional allowances or charges against income. The Company determines its allowance for doubtful accounts by first considering all known collectibility problems of customers' accounts, and then applying certain percentages against the various aging categories of the remaining receivables. The resulting allowance for doubtful accounts receivable is an estimate based upon the Company's knowledge of its business and customer base, and historical trends. The Company also establishes allowances, at the time revenue is recognized, for returns and allowances, discounts, pricing and other possible customer deductions. These allowances are based upon historical trends.

The following table presents the Company's net accounts receivable at the dates indicated.

| (In thousands) | December 31, 2008 | June 30, 2008 |
|--------------------------------------|----------------------|------------------|
| Accounts receivable | \$ 36,040 | \$ 39,442 |
| less Allowance for doubtful accounts | (819) | (585) |
| Accounts receivable, net | \$ 35,221 | \$ 38,857 |

Facilities Expansion Tax Incentives and Credits:

The Company periodically receives either tax incentives or credits for state income taxes when it expands a facility and/or its level of employment in certain states within which it operates. A tax incentive is amortized to income over the time period that the state could be entitled to return of the tax incentive if the expansion or job growth were not maintained, and is recorded as a reduction of either manufacturing overhead or administrative expenses. A credit is amortized to income over the time period that the state could be entitled to return of the credit if the expansion were not maintained, is recorded as a reduction of state income tax expense, and is subject to a valuation allowance review if the credit cannot immediately be utilized.

Short-Term Investments:

Short-term investments consist of tax free (federal) investments in high grade government agency backed bonds for which the interest rate resets weekly and the Company has a seven day put option. These investments are classified as available-for-sale securities and are stated at fair market value, which represents the most recent reset amount at period end. The Company invested in these types of short-term investments during the first half of fiscal 2008. There were no such investments in the first quarter of FY 2009.

Cash and Cash Equivalents:

The cash balance includes cash and cash equivalents which have original maturities of less than three months. At December 31, 2008 and June 30, 2008, the bank balances included \$0 and \$3,376,000, respectively, in excess of FDIC insurance limits.

Inventories:

Inventories are stated at the lower of cost or market. Cost is determined on the first-in, first-out basis.

Property, Plant and Equipment and Related Depreciation:

Property, plant and equipment are stated at cost. Major additions and betterments are capitalized while maintenance and repairs are expensed. For financial reporting purposes, depreciation is computed on the straight-line method over the estimated useful lives of the assets as follows:

| | |
|-------------------------|---------------|
| Buildings | 31 - 40 years |
| Machinery and equipment | 3 - 10 years |
| Computer software | 3 - 8 years |

Costs related to the purchase, internal development, and implementation of the Company's fully integrated enterprise resource planning/business operating software system are either capitalized or expensed in accordance with the American Institute of Certified Public Accountants' Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." The current business operating software was first implemented in January 2000. All costs capitalized for the business operating software are being depreciated over an eight year life from the date placed in service. Other purchased computer software is being depreciated over periods ranging from three to five years. Leasehold improvements are depreciated over the shorter of fifteen years or the remaining term of the lease.

The following table presents the Company's property, plant and equipment at the dates indicated.

| (In thousands) | December 31, 2008 | June 30, 2008 |
|--|----------------------|------------------|
| Property, plant and equipment, at cost | \$ 102,778 | \$ 102,132 |
| less Accumulated depreciation | (60,074) | (57,378) |
| Property, plant and equipment, net | \$ 42,704 | \$ 44,754 |

Intangible Assets:

Intangible assets consisting of customer relationships, trade names and trademarks, patents, technology and software, and non-compete agreements are recorded on the Company's balance sheet. The definite-lived intangible assets are being amortized to expense on a straight line basis over periods ranging between two and forty years. The excess of cost over fair value of assets acquired ("goodwill") is not amortized but is subject to review for impairment. See additional information about goodwill and intangibles in Note 7. The Company periodically evaluates intangible assets, goodwill and other long-lived assets for permanent impairment.

Fair Value of Financial Instruments:

The Company has financial instruments consisting primarily of cash and cash equivalents, short-term investments, revolving lines of credit, and long-term debt. The fair value of these financial instruments approximates carrying value because of their short-term maturity and/or variable, market-driven interest rates. The Company has no financial instruments with off-balance sheet risk.

Product Warranties:

The Company offers a limited warranty that its products are free of defects in workmanship and materials. The specific terms and conditions vary somewhat by product line, but generally cover defects returned within one to five years from date of shipment. The Company records warranty liabilities to cover the estimated future costs for repair or replacement of defective returned products as well as products that need to be repaired or replaced in the field after installation. The Company calculates its liability for warranty claims by applying estimates to cover unknown claims, as well as estimating the total amount to be incurred for known warranty issues. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary.

Changes in the Company's warranty liabilities, which are included in accrued expenses in the accompanying consolidated balance sheets, during the periods indicated below were as follows:

| (In thousands) | December 31, 2008 | June 30, 2008 |
|---|----------------------|------------------|
| Balance at beginning of the period | \$ 257 | \$ 314 |
| Additions charged to expense | 53 | 1,141 |
| Deductions for repairs and replacements | (95) | (1,198) |
| Balance at end of the period | \$ 215 | \$ 257 |

Contingencies:

The Company is party to various negotiations, customer bankruptcies, and legal proceedings arising in the normal course of business. The Company provides reserves for these matters when a loss is probable and reasonably estimable. In the opinion of management, the ultimate disposition of these matters will not have a material adverse effect on the Company's financial position, results of operations, cash flows or liquidity (see Note 12).

Research and Development Costs:

Research and development expenses are costs directly attributable to new product development and consist of salaries, payroll taxes, employee benefits, materials, supplies, depreciation and other administrative costs. All costs are expensed as incurred and are classified as operating expenses. Research and development costs incurred total \$1,035,000 and \$875,000 for the three month periods ended December 31, 2008 and 2007, respectively, and \$2,066,000 and \$1,719,000 for the six month periods ended December 31, 2008 and 2007, respectively.

Earnings Per Common Share:

The computation of basic earnings per common share is based on the weighted average common shares outstanding for the period net of treasury shares held in the Company's non-qualified deferred compensation plan. The computation of diluted earnings per share is based on the weighted average common shares outstanding for the period and includes common share equivalents. Common share equivalents include the dilutive effect of stock options, contingently issuable shares and common shares to be issued under a deferred compensation plan, all of which totaled zero shares and 304,000 shares for the three months ended December, 2008 and 2007, respectively, and zero shares and 299,000 shares for the six months ended December 31, 2008 and 2007, respectively. See also Note 5.

Stock Options:

There were no disqualifying dispositions of shares from stock option exercises in the first six months of fiscal 2009. The Company recorded \$212,300 in the first six months of fiscal 2008 as a reduction of federal income taxes payable, \$205,900 as an increase in additional paid in capital, and \$6,400 as a reduction of income tax expense to reflect the tax credits it will receive as a result of disqualifying dispositions of shares from stock option exercises. This had the effect of reducing cash flow from operating activities and increasing cash flow from financing activities by \$205,900. See further discussion in Note 11.

New Accounting Pronouncements:

In July 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109." FIN 48 provides guidance for the recognition, measurement, classification and disclosure of the financial statement effects of a position taken or expected to be taken in a tax return ("tax position"). The financial statement effects of a tax position must be recognized when there is a likelihood of more than 50 percent

that based on the technical merits, the position will be sustained upon examination and resolution of the related appeals or litigation processes, if any. A tax position that meets the recognition threshold must be measured initially and subsequently as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority. In addition, FIN 48 specifies certain annual disclosures that are required to be made once the interpretation has taken effect. The interpretation was effective for fiscal years beginning after December 15, 2006. The Company adopted the provisions of FIN 48 on July 1, 2007. As a result of adoption, the Company recognized a \$2,582,000 increase to reserves for uncertain tax positions and recorded a charge of \$2,582,000 to the July 1, 2007 retained earnings balance. For additional information, see Note 9 to the Consolidated Financial Statements.

In September 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 157, "Fair Value Measurements." This Statement provides a new definition of fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. The Statement applies under other accounting pronouncements that require or permit fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007, or the Company's fiscal year 2009. Two FASB Staff Positions (FSP) were subsequently issued. In February 2007, FSP No. 157-2 delayed the effective date of this SFAS No. 157 for non-financial assets and non-financial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. This FSP is effective for fiscal years beginning after November 15, 2008, or the Company's fiscal year 2010. FSP No. 157-1, also issued in February 2007, excluded FASB No. 13 "Accounting for Leases" and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under FASB No. 13. However, this scope exception does not apply to assets acquired and liabilities assumed in a business combination that are required to be measured at fair value under FASB Statement No. 141, "Business Combinations" or FASB No. 141R, "Business Combinations." This FSP is effective upon initial adoption of SFAS No. 157. The Company adopted SFAS No. 157 on July 1, 2008, and the adoption did not have any significant impact on its consolidated results of operations, cash flows or financial position. The Company determined that it does not have any financial assets or liabilities subject to the disclosure requirements of SFAS No. 157, and is evaluating the disclosure impact on its non-financial assets and liabilities.

In February 2007, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities." This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The election is made on an instrument-by-instrument basis and is irrevocable. If the fair value option is elected for an instrument, SFAS No. 159 specifies that all subsequent changes in fair value for that instrument shall be reported in earnings. The objective of the pronouncement is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, or in the Company's case, July 1, 2008. The Company has not made any fair value elections under SFAS No. 159 and did not have any impact on its consolidated results of operations, cash flows or financial position.

In December 2007, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards (“SFAS”) No. 141 (revised 2007), “Business Combinations,” which replaces SFAS No. 141. The statement retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It also changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition related costs as incurred. SFAS No. 141R is effective beginning July 1, 2009 and will apply prospectively to business combinations completed on or after that date.

Comprehensive Income:

The Company does not have any comprehensive income items other than net income.

Reclassifications:

Immaterial reclassifications may have been made to prior year amounts in order to be consistent with the presentation for the current year, including elimination of the separate breakout of Net Sales – Installation on the face of the Condensed Consolidated Statements of Operations.

Use of Estimates:

The preparation of the financial statements in conformity with accounting principles generally accepted in the United States of America requires the Company to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

NOTE 3: MAJOR CUSTOMER CONCENTRATIONS

The Company sells both lighting and graphics products into its most significant market, the petroleum / convenience store market, with approximately 22% and 34% of total net sales concentrated in this market for the three months ended December 31, 2008 and 2007, respectively and approximately 21% and 32% of total net sales concentrated in this market for the six month periods ended December 31, 2008 and 2007, respectively.

The Company’s net sales to a major customer in the Graphics Segment, 7-Eleven, Inc., represented approximately \$17,490,000, or 10% of consolidated net sales in the six months ended December 31, 2007.

NOTE 4: BUSINESS SEGMENT INFORMATION

Statement of Financial Accounting Standards (SFAS) No. 131, “Disclosures about Segments of an Enterprise and Related Information,” establishes standards for reporting information regarding operating segments in annual financial statements and requires selected information of those segments to be presented in interim financial statements. Operating segments are identified as components of an enterprise for which separate discrete financial information is available for evaluation by the chief operating decision maker (the Company’s President and Chief Executive Officer) in making decisions on how to allocate resources and assess performance. While the Company has thirteen operating segments, it has only two reportable operating business segments: Lighting and Graphics. These segments are strategic business units organized around product categories that follow management’s internal organization structure with a President of LSI Lighting Solutions Plus and a President of LSI Graphics Solutions Plus reporting directly to the Company’s President and Chief Executive Officer.

The Lighting Segment includes outdoor, indoor, and landscape lighting that has been fabricated and assembled for the commercial, industrial and multi-site retail lighting markets, including the petroleum/convenience store market. The Lighting Segment includes the operations of LSI Ohio Operations, LSI Metal Fabrication, LSI MidWest Lighting, LSI Lightron and LSI Greenlee Lighting. These operations have been integrated and have similar economic characteristics. LSI Marcole, which produces wire harnesses used in the Company's lighting products and also manufactures electric wiring used by appliance manufacturers in commercial and industrial markets, has been aggregated into the Lighting Segment based on management's plans to continue to integrate its Lighting operations by increasing its intercompany volume.

The Graphics Segment designs, manufactures and installs exterior and interior visual image elements related to image programs, menu board systems, solid state LED digital advertising billboards, and solid state LED digital sports and entertainment video screens. These products are used in visual image programs in several markets, including the petroleum/convenience store market and multi-site retail operations. The Graphics Segment includes the operations of Grady McCauley, LSI Retail Graphics and LSI Integrated Graphic Systems, which have been aggregated as such facilities manufacture two-dimensional graphics with the use of screen and digital printing, fabricate three-dimensional structural graphics sold in the multi-site retail and petroleum/convenience store markets, and exhibit each of the similar economic characteristics and meet the other requirements outlined in paragraph 17 of SFAS No. 131. The Graphics Segment also includes LSI Images, which manufactures three-dimensional menu board systems, LSI Adapt, which provides customers with surveying, permitting, engineering and installation services related to products of the Graphics Segment, the solid-state LED billboards and sports video boards, and the Smartvision video screens for the entertainment market.

In its evaluation of business segment reporting, the Company determined that the total of external revenues reported by the operating segments in the Lighting Segment (LSI Ohio Operations, LSI Metal Fabrication, LSI MidWest Lighting, LSI Lightron, Greenlee Lighting) and the operating segments in the Graphics Segment (Grady McCauley, LSI Retail Graphics and LSI Integrated Graphic Systems) comprised more than 75% of total consolidated revenue.

Summarized financial information for the Company's reportable business segments for the three and six months ended December 31, 2008 and 2007, and as of December 31, 2008 and June 30, 2008 is as follows:

| (In thousands) | Three Months Ended | | Six Months Ended | |
|---------------------------------|--------------------|-----------|------------------|------------|
| | December 31 | | December 31 | |
| | 2008 | 2007 | 2008 | 2007 |
| Net sales: | | | | |
| Lighting Segment | \$ 45,290 | \$ 48,811 | \$ 96,050 | \$ 96,725 |
| Graphics Segment | 15,497 | 35,251 | 40,575 | 77,338 |
| | \$ 60,787 | \$ 84,062 | \$ 136,625 | \$ 174,063 |
| Operating income (loss): | | | | |
| Lighting Segment | \$ (11,761) | \$ 3,731 | \$ (9,111) | \$ 7,498 |
| Graphics Segment | (1,665) | 3,978 | (99) | 10,937 |
| | \$ (13,426) | \$ 7,709 | \$ (9,210) | \$ 18,435 |
| Capital expenditures: | | | | |
| Lighting Segment | \$ 393 | \$ 1,321 | \$ 765 | \$ 1,868 |
| Graphics Segment | 20 | 539 | 123 | 675 |
| | \$ 413 | \$ 1,860 | \$ 888 | \$ 2,543 |

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Depreciation and amortization:

| | | | | | | | | |
|------------------|----|-------|----|-------|----|-------|----|-------|
| Lighting Segment | \$ | 1,531 | \$ | 1,438 | \$ | 2,652 | \$ | 2,783 |
| Graphics Segment | | 455 | | 811 | | 1,324 | | 1,688 |
| | \$ | 1,986 | \$ | 2,249 | \$ | 3,976 | \$ | 4,471 |

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| | December 31, 2008 | June 30, 2008 |
|-----------------------------|----------------------|------------------|
| Identifiable assets: | | |
| Lighting Segment | \$ 88,052 | \$ 107,627 |
| Graphics Segment | 49,400 | 55,529 |
| | 137,452 | 163,156 |
| Corporate | 19,815 | 20,384 |
| | \$ 157,267 | \$ 183,540 |

Segment net sales represent sales to external customers. Intersegment revenues were eliminated in consolidation as follows:

| (In thousands) | Three Months Ended December 31 | | Six Months Ended December 31 | |
|--|-----------------------------------|----------|---------------------------------|----------|
| | 2008 | 2007 | 2008 | 2007 |
| Lighting Segment net sales to the Graphics Segment | \$ 634 | \$ 1,277 | \$ 4,079 | \$ 2,699 |
| Graphics Segment net sales to the Lighting Segment | \$ 657 | \$ 224 | \$ 2,566 | \$ 979 |

Segment operating income, which is used in management's evaluation of segment performance, represents net sales less all operating expenses including allocations of corporate expense, but excluding interest expense.

Identifiable assets are those assets used by each segment in its operations, including allocations of shared assets. Corporate assets consist primarily of cash and cash equivalents, refundable income taxes and certain intangible assets.

The Company considers its geographic areas to be: 1) the United States, and 2) Canada. The majority of the Company's operations are in the United States; one operation is in Canada. The geographic distribution of the Company's net sales and long-lived assets are as follows:

| (In thousands) | Three Months Ended December 31 | | Six Months Ended December 31 | |
|-----------------------|-----------------------------------|-----------|---------------------------------|------------|
| | 2008 | 2007 | 2008 | 2007 |
| Net sales (a): | | | | |
| United States | \$ 59,615 | \$ 82,559 | \$ 132,635 | \$ 169,488 |
| Canada | 1,172 | 1,503 | 3,990 | 4,575 |
| | \$ 60,787 | \$ 84,062 | \$ 136,625 | \$ 174,063 |

| | December 31, 2008 | June 30, 2008 |
|------------------------|----------------------|------------------|
| Long-lived assets (b): | | |
| United States | \$ 46,783 | \$ 48,228 |
| Canada | 731 | 898 |
| | \$ 47,514 | \$ 49,126 |

(a) Net sales are attributed to geographic areas based upon the location of the operation making the sale.

(b) Long-lived assets includes property, plant and equipment, and other long term assets.

NOTE EARNINGS PER COMMON SHARE

5:

The following table presents the amounts used to compute earnings or (loss) per common share and the effect of dilutive potential common shares on net income and weighted average shares outstanding (in thousands, except per share data):

| | Three Months Ended December 31 | | Six Months Ended December 31 | |
|---|-----------------------------------|----------|---------------------------------|-----------|
| | 2008 | 2007 | 2008 | 2007 |
| BASIC EARNINGS (LOSS) PER SHARE | | | | |
| Net income (loss) | \$ (13,062) | \$ 4,823 | \$ (10,375) | \$ 11,776 |
| Weighted average shares outstanding during the period, | | | | |
| net of treasury shares (a) | 21,571 | 21,548 | 21,575 | 21,528 |
| Weighted average shares outstanding in the Deferred Compensation Plan during the period | 228 | 211 | 223 | 209 |
| Weighted average shares outstanding | 21,799 | 21,759 | 21,798 | 21,737 |
| Basic earnings (loss) per share | \$ (0.60) | \$ 0.22 | \$ (0.48) | \$ 0.54 |
| DILUTED EARNINGS (LOSS) PER SHARE | | | | |
| Net income (loss) | \$ (13,062) | \$ 4,823 | \$ (10,375) | \$ 11,776 |
| Weighted average shares outstanding - Basic | 21,799 | 21,759 | 21,798 | 21,737 |
| Effect of dilutive securities (b): | | | | |
| Impact of common shares to be issued under | -- | 304 | -- | 299 |

stock option plans, and
contingently issuable
shares, if any

| | | | | |
|-------------------------------------|-----------|---------|-----------|---------|
| Weighted average shares outstanding | | | | |
| (c) | 21,799 | 22,063 | 21,798 | 22,036 |
| Diluted earnings (loss) per share | \$ (0.60) | \$ 0.22 | \$ (0.48) | \$ 0.53 |

(a) Includes shares accounted for like treasury stock in accordance with EITF 97-14.

(b) Calculated using the "Treasury Stock" method as if dilutive securities were exercised and the funds were used to purchase common shares at the average market price during the period.

(c) Options to purchase 1,513,335 common shares and 491,868 common shares during the three month periods ending December 31, 2008 and 2007, respectively, and options to purchase 1,422,031 common shares and 401,978 common shares during the six month periods ending December 31, 2008 and 2007, respectively, were not included in the computation of diluted earnings per share because the exercise price was greater than the average fair market value of the common shares.

NOTE BALANCE SHEET DATA

6:

The following information is provided as of the dates indicated (in thousands):

| | December 31, 2008 | June 30, 2008 |
|-------------------------------------|----------------------|------------------|
| Inventories | | |
| Raw materials | \$ 23,467 | \$ 25,150 |
| Work-in-process | 5,800 | 7,955 |
| Finished goods | 14,651 | 17,404 |
| | \$ 43,918 | \$ 50,509 |
| Accrued Expenses | | |
| Compensation and benefits | \$ 4,695 | \$ 7,060 |
| Customer prepayments | 883 | 1,820 |
| Accrued Commissions | 1,041 | 1,552 |
| Legal settlement | -- | 2,800 |
| Other accrued expenses | 2,479 | 2,756 |
| | \$ 9,098 | \$ 15,988 |
| Other Long-Term Liabilities | | |
| Reserve for uncertain tax positions | \$ 2,761 | \$ 3,225 |
| Other long-term liabilities | 326 | 359 |
| | \$ 3,087 | \$ 3,584 |

NOTE 7: GOODWILL AND OTHER INTANGIBLE ASSETS

The Company performed its annual goodwill impairment test as of July 1, 2008. However, because the conditions of impairment were present at June 30, 2008, the resulting estimated impairment was recorded in the fourth quarter of fiscal year 2008. No impairment charge was recorded in the first quarter of fiscal year 2009. For purposes of this test, the Company determined that it had six reporting units of which four have goodwill. Based upon the Company's preliminary analysis, it was determined that the goodwill associated with two reporting units, totaling \$27,149,000, was fully impaired. It was also determined that other intangible assets associated with three reporting units was either fully or partially impaired. The total amount of impairment associated with other intangible assets was \$1,780,000. Total impairment for both goodwill and other intangible assets was \$28,929,000. The majority of impairment charges occurred within the Graphics Segment and totaled \$27,832,000. The remaining impairment charge

of \$1,097,000 occurred within the Lighting Segment. The majority of the impairment charge in the Lighting Segment occurred as a result of the fiscal 2008 review of long-lived assets in connection with Statement of Financial Accounting Standard (SFAS) No. 144, "Accounting for the Impairment or Disposal of Long-lived Assets." It was determined that a certain trade name was fully impaired because it was no longer used in the Company's marketing efforts. An impairment charge of \$746,000 was recorded as of June 30, 2008 related to this trade name. The remaining impairment charge of \$28,183,000 was primarily comprised of goodwill and was a direct result of the SFAS No. 142 testing. This impairment charge was due primarily to the combination of a decline in the market capitalization of the Company at June 30, 2008 and the decline in the estimated forecasted discounted cash flows expected by the Company. This impairment charge was recorded in the fourth quarter of fiscal 2008 rather than in the first quarter of fiscal 2009 due to the decline in the Company's stock price as of June 30, 2008. Because step two of the goodwill impairment testing was not complete, an estimate of the impairment charge was recorded as of June 30, 2008. The impairment test was completed in the first quarter of fiscal 2009 at which time it was determined that no further adjustment to the estimate, recorded at June 30, 2008, was needed. A similar analysis was performed in fiscal 2008 as of July 1, 2007 and there was no impairment of goodwill.

Due to current economic conditions, the effects of the recession on the Company's markets and the decline in the Company's stock price, management believed that an additional goodwill impairment test was required as of December 31, 2008. Based upon the Company's preliminary analysis, it was determined that the goodwill associated with the two remaining reporting units that contain goodwill was either fully or partially impaired. The total amount of the estimated goodwill impairment was \$12,669,000, of which \$11,320,000 was full impairment of the goodwill within one reporting unit in the Lighting Segment and \$1,349,000 represents a partial impairment of the goodwill within one reporting unit in the Graphics Segment. The impairment charge was due to a combination of a decline in the market capitalization of the Company at December 31, 2008 and a decline in the estimated forecasted discounted cash flows since the annual goodwill impairment test was performed. The impairment charge was recorded in the second quarter and is considered an estimate, subject to completion of our valuation procedures.

The Company relies upon a number of factors, judgments and estimates when conducting its impairment testing. These include operating results, forecasts, anticipated future cash flows and market place data, to name a few. There are inherent uncertainties related to these factors and judgments in applying them to the analysis of goodwill impairment.

The following tables present information about the Company's goodwill and other intangible assets on the dates or for the periods indicated.

| (in thousands) | As of December 31, 2008 | | | As of June 30, 2008 | | |
|-------------------------|-------------------------|--------------------------|-----------|---------------------|--------------------------|-----------|
| | Carrying Amount | Accumulated Amortization | Net | Carrying Amount | Accumulated Amortization | Net |
| Goodwill | \$ 2,382 | \$ -- | \$ 2,382 | \$ 15,427 | \$ 376 | \$ 15,051 |
| Other Intangible Assets | \$ 22,219 | \$ 8,198 | \$ 14,021 | \$ 22,219 | \$ 7,159 | \$ 15,060 |

| | Amortization Expense of Other Intangible Assets | |
|--------------------|--|----------------------|
| | December 31, 2008 | December 31, 2007 |
| Three Months Ended | \$ 520 | \$ 583 |
| Six Months Ended | \$ 1,039 | \$ 1,164 |

The Company expects to record amortization expense over each of the next five years as follows: 2009 through 2012 -- \$2,079,000; 2013 -- \$1,818,000.

The carrying amounts of goodwill are as follows:

| (in thousands) | December 31, 2008 | June 30, 2008 |
|------------------|----------------------|------------------|
| Lighting Segment | \$ -- | \$ 11,320 |
| Graphics Segment | 2,382 | 3,731 |
| Total | \$ 2,382 | \$ 15,051 |

The gross carrying amount and accumulated amortization by major other intangible asset class is as follows:

| (in thousands) | December 31, 2008 | | June 30, 2008 | |
|--|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Intangible Assets | | | | |
| Amortized Intangible Assets | | | | |
| Customer relationships | \$ 7,472 | \$ 3,897 | \$ 7,472 | \$ 3,620 |
| Patents | 110 | 56 | 110 | 52 |
| LED Technology firmware, software | 10,448 | 3,731 | 10,448 | 2,985 |
| Non-compete agreements | 630 | 514 | 630 | 502 |
| | 18,660 | 8,198 | 18,660 | 7,159 |
| Indefinite-lived Intangible Assets Trademarks and trade names | | | | |
| | 3,559 | -- | 3,559 | -- |
| | 3,559 | -- | 3,559 | -- |
| Total Intangible Assets | \$ 22,219 | \$ 8,198 | \$ 22,219 | \$ 7,159 |

NOTE 8: REVOLVING LINES OF CREDIT AND LONG-TERM DEBT

The Company has an unsecured \$50 million revolving line of credit with its bank group in the U.S., all of which was available as of December 31, 2008. While there have been some borrowings on this line of credit during the first half of fiscal 2009, there are no borrowings against this line of credit as of December 31, 2008. A portion of this credit facility is a \$20 million line of credit that expires in the third quarter of fiscal 2009. The remainder of the credit facility is a \$30 million three year committed line of credit that expires in fiscal 2011. Annually in the third quarter,

the credit facility is renewable with respect to adding an additional year of

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commitment to replace the year just ended. Interest on the revolving lines of credit is charged based upon an increment over the LIBOR rate as periodically determined, an increment over the Federal Funds Rate as periodically determined, or at the bank's base lending rate, at the Company's option. The increment over the LIBOR borrowing rate, as periodically determined, fluctuates between 50 and 75 basis points depending upon the ratio of indebtedness to earnings before interest, taxes, depreciation and amortization (EBITDA). The increment over the Federal Funds borrowing rate, as periodically determined, fluctuates between 150 and 200 basis points, and the commitment fee on the unused balance of the \$30 million committed portion of the line of credit fluctuates between 15 and 25 basis points based upon the same leverage ratio. Under terms of these agreements, the Company has agreed to a negative pledge of assets, to maintain minimum levels of profitability and net worth, and is subject to certain maximum levels of leverage.

The Company also established a \$7 million line of credit for its Canadian subsidiary. The line of credit expires in the third quarter of fiscal 2009. Interest on the Canadian subsidiary's line of credit is charged based upon an increment over the LIBOR rate or based upon an increment over the United States base rates if funds borrowed are denominated in U.S. dollars or an increment over the Canadian prime rate if funds borrowed are denominated in Canadian dollars. While there has been activity in this line of credit during the first six months of fiscal 2009, there are no borrowings against this line of credit as of December 31, 2008.

The Company is in compliance with all of its loan covenants as of December 31, 2008.

NOTE 9: RESERVE FOR UNCERTAIN TAX LIABILITIES

The Company adopted the provisions of FASB Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes," on July 1, 2007. As a result of adoption, the Company recognized \$2,582,000 in reserves for uncertain tax positions and recorded a charge of \$2,582,000 to the July 1, 2007 retained earnings balance. At June 30, 2008, tax and interest, net of potential federal tax benefits, were \$2,098,000 and \$534,000, respectively, of the total reserves of \$3,225,000. Additionally, penalties were \$593,000 of the reserve at June 30, 2008. Of the \$3,225,000 reserve for uncertain tax positions, \$2,632,000 would have an unfavorable impact on the effective tax rate if recognized.

For the six months ended December 31, 2008, the Company recognized an additional \$31,000 tax expense related to the increase in reserves for uncertain tax positions, paid net liabilities totaling \$162,000, and reduced the reserve by \$333,000 through the income tax provision as a result of a voluntary disclosure agreement and filing making this portion of the liability no longer required. As of December 31, 2008, the reserve for uncertain income tax liabilities is \$2,761,000, net of potential federal tax benefits. The Company is recording estimated interest and penalties related to potential underpayment of income taxes as a component of tax expense in the Condensed Consolidated Statements of Operation. The reserve for uncertain tax positions is not expected to change significantly in the next 12 months.

The Company files a consolidated federal income tax return in the United States, and files various combined and separate tax returns in several state and local jurisdictions. With limited exceptions, the Company is no longer subject to U.S. Federal, state and local tax examinations by tax authorities for fiscal years ending prior to June 30, 2006. The Internal Revenue Service has completed its audit of the Company's fiscal year 2006 Federal Income Tax Return and has not required any changes to the return as filed.

NOTECASH DIVIDENDS

10:

The Company paid cash dividends of \$4,314,000 and \$7,107,000 in the six month periods ended December 31, 2008 and 2007, respectively. In January, 2009, the Company's Board of Directors declared a \$0.05 per share regular quarterly cash dividend (approximately \$1,079,000) payable on February 10, 2009 to shareholders of record as of February 3, 2009.

NOTE EQUITY COMPENSATION

11:

Stock Options

The Company has an equity compensation plan that was approved by shareholders which covers all of its full-time employees, outside directors and advisors. The options granted or stock awards made pursuant to this plan are granted at fair market value at date of grant or award. Options granted to non-employee directors become exercisable 25% each ninety days (cumulative) from date of grant and options granted to employees generally become exercisable 25% per year (cumulative) beginning one year after the date of grant. Prior to fiscal 2007, options granted to non-employee directors were immediately exercisable. The number of shares reserved for issuance is 2,250,000, of which 926,363 shares were available for future grant or award as of December 31, 2008. This plan allows for the grant of incentive stock options, non-qualified stock options, stock appreciation rights, restricted and unrestricted stock awards, performance stock awards, and other stock awards. As of December 31, 2008, a total of 1,517,700 options for common shares were outstanding from this plan as well as two previous stock option plans (both of which had also been approved by shareholders), and of these, a total of 814,700 options for common shares were vested and exercisable. The approximate unvested stock option expense as of December 31, 2008 that will be recorded as expense in future periods is \$2,566,900. The weighted average time over which this expense will be recorded is approximately 21 months.

The fair value of each option on the date of grant was estimated using the Black-Scholes option pricing model. The below listed weighted average assumptions were used for grants in the periods indicated.

| | Three Months Ended | | Six Months Ended | |
|-------------------------|--------------------|----------|------------------|----------|
| | 12/31/08 | 12/31/07 | 12/31/08 | 12/31/07 |
| Dividend yield | 5.16% | 3.27% | 5.16% | 3.27% |
| Expected volatility | 41% | 32% | 41% | 36% |
| Risk-free interest rate | 2.16% | 3.8% | 3.1% | 4.3% |
| Expected life | 4.3 yrs. | 4.3 yrs. | 4.3 yrs. | 4.3 yrs. |

At December 31, 2008, the 339,300 options granted in the first six months of fiscal 2009 to both employees and non-employee directors had exercise prices ranging from \$4.60 to \$8.98, fair values ranging from \$1.12 to \$2.21, and remaining contractual lives of between four years and eleven months and nine years and eleven months.

At December 31, 2007, the 327,900 options granted in the first six months of fiscal 2008 to employees and non-employee directors had exercise prices ranging from \$17.80 to \$19.76, fair values ranging from \$4.19 to \$5.70 per option, and remaining contractual lives of between four years and eight months and nine years and eight months.

The Company records stock option expense using a straight line Black-Scholes method with an estimated 4.2% forfeiture rate (revised in the second quarter of fiscal 2008 from the 10% forfeiture rate previously used). The expected volatility of the Company's stock was calculated based upon the historic monthly fluctuation in stock price for a period approximating the expected life of option grants. The risk-free interest rate is the rate of a five year Treasury security at constant, fixed maturity on the approximate date of the stock option grant. The expected life of outstanding options is determined to be less than the contractual term for a period equal to the aggregate group of option holders' estimated weighted average time within which options will be exercised. It is the Company's policy that when stock options are exercised, new common shares shall be issued. The Company recorded \$295,700 and \$327,300 of expense related to stock options in the three months ended December 31, 2008 and 2007, respectively, and \$645,100 and \$599,400 in the six month periods ended December 31, 2008 and 2007, respectively. As of December 31, 2008, the Company expects that approximately 668,800 outstanding stock options having a weighted average exercise price of \$14.12, no aggregate intrinsic value, and weighted average remaining contractual terms of 8.7 years will vest in the future.

Information related to all stock options for the periods ended December 31, 2008 and 2007 is shown in the table below:

| | Shares | Six Months Ended December 31, 2008 | | |
|----------------------------|-----------|--|---|---------------------------------|
| | | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
| Outstanding at 6/30/08 | 1,197,482 | \$ 14.44 | | \$ -- |
| Granted | 339,300 | \$ 8.89 | | |
| Forfeitures | (19,082) | | | |
| Exercised | -- | n/a | | |
| Outstanding at 12/31/08 | 1,517,700 | \$ 13.21 | 6.8 years | \$ 14,380 |
| Exercisable at 12/31/08 | 814,700 | \$ 12.52 | 5.2 years | \$ -- |

| | Shares | Six Months Ended December 31, 2007 | | |
|----------------------------|-----------|--|---|---------------------------------|
| | | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
| Outstanding at 6/30/07 | 983,788 | \$ 12.16 | | \$ 5,642,400 |
| Granted | 327,900 | \$ 19.75 | | |
| Forfeitures | (5,125) | \$ 16.60 | | |
| Exercised | (79,006) | \$ 9.45 | | |
| Outstanding at 12/31/07 | 1,227,557 | \$ 14.35 | 7.1 years | \$ 5,235,800 |
| Exercisable at 12/31/07 | 618,782 | \$ 11.16 | 5.2 years | \$ 4,357,100 |

The aggregate intrinsic value of options exercised during the six months ended December 31, 2007 was \$836,300. No options were exercised in the six months ended December 31, 2008.

The Company received \$642,000 of cash and 5,093 common shares of the Company's stock from employees who exercised 79,006 options during the six months ended December 31, 2007. Additionally, in this six month period, the Company recorded \$212,300 as a reduction of federal income taxes payable, \$205,900 as an increase in common stock, and \$6,400 as a reduction of income tax expense related to the exercises of stock options in which the employees sold the common shares prior to the passage of twelve months from the date of exercise.

Information related to unvested stock options for the three months ended December 31, 2008 is shown in the table below:

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|---|-----------|--|---|------------------------------|
| Outstanding unvested stock options at 6/30/08 | 582,000 | \$ 17.62 | 8.2 years | \$ -- |
| Vested | (212,750) | \$ 15.62 | | |
| Forfeitures | (5,550) | \$ 16.55 | | |
| Granted | 339,300 | \$ 8.89 | | |
| Outstanding unvested stock options at 12/31/08 | 703,000 | \$ 14.02 | 8.7 years | \$ 14,380 |

Stock Compensation Awards

The Company awarded a total of 2,552 common shares in the six months ended December 31, 2008, valued at their approximate \$20,000 fair market value on the date of issuance pursuant to the compensation programs for non-employee Directors who receive a portion of their compensation as an award of Company stock. Stock compensation awards are made in the form of newly issued common shares of the Company.

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Deferred Compensation Plan

The Company has a non-qualified deferred compensation plan providing for both Company contributions and participant deferrals of compensation. The Plan is fully funded in a Rabbi Trust. All Plan investments are in common shares of the Company. As of December 31, 2008 there were 35 participants and all but one had fully vested account balances. A total of 229,199 common shares with a cost of \$2,580,500, and 211,151 common shares with a cost of \$2,426,800 were held in the Plan as of December 31, 2008 and June 30, 2008, respectively, and, accordingly, have been recorded as treasury shares. The change in the number of shares held by this Plan is the net result of share purchases and sales on the open stock market for compensation deferred into the Plan and for distributions to terminated employees. The Company does not issue new common shares for purposes of the non-qualified deferred compensation plan. The Company accounts for assets held in the non-qualified deferred compensation plan in accordance with Emerging Issues Task Force 97-14, "Accounting for Deferred Compensation Arrangements where amounts earned are held in a Rabbi Trust and invested." For fiscal year 2009, the Company estimates the Rabbi Trust for the Nonqualified Deferred Compensation Plan will make net repurchases in the range of 21,000 to 25,000 common shares of the Company. During the six months ended December 31, 2008 and 2007, the Company used approximately \$160,700 and \$214,500, respectively, to purchase common shares of the Company in the open stock market for either employee salary deferrals or Company contributions into the non-qualified deferred compensation plan. The Company does not currently repurchase its own common shares for any other purpose.

NOTE 12: LOSS CONTINGENCY RESERVE

The Company is party to various negotiations and legal proceedings arising in the normal course of business, most of which are dismissed or resolved with minimal expense to the Company, exclusive of legal fees. Since October 2000, the Company has been the defendant in a complex lawsuit alleging patent infringement with respect to some of the Company's menu board systems sold over the past approximately eleven years. Pursuant to settlement discussions initiated by the plaintiffs, the Company made a \$2,800,000 offer to settle this matter and, accordingly, recorded a loss contingency reserve in the fourth quarter of fiscal 2008. Following additional discussions in the second quarter of fiscal 2009, the Company reached a full and complete settlement of all matters related to this menu board patent infringement lawsuit. Accordingly, an additional \$200,000 expense was recorded in the second quarter of fiscal 2009 and a payment of \$3,000,000 was made to the plaintiffs.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Net Sales by Business Segment

| (In thousands) | Three Months Ended | | Six Months Ended | |
|------------------|--------------------|-----------|------------------|------------|
| | December 31 | | December 31 | |
| | 2008 | 2007 | 2008 | 2007 |
| Lighting Segment | \$ 45,290 | \$ 48,811 | \$ 96,050 | \$ 96,725 |
| Graphics Segment | 15,497 | 35,251 | 40,575 | 77,338 |
| | \$ 60,787 | \$ 84,062 | \$ 136,625 | \$ 174,063 |

The Company's "forward looking statements" and disclosures as presented earlier in this Form 10-Q in the "Safe Harbor" Statement should be referred to when reading Management's Discussion and Analysis of Financial Condition and Results of Operations.

Results of Operations

THREE MONTHS ENDED DECEMBER 31, 2008 COMPARED TO THREE MONTHS ENDED DECEMBER 31, 2007

Net sales of \$60,787,000 in the second quarter of fiscal 2009 decreased 27.7% from fiscal 2008 second quarter net sales of \$84,062,000. Lighting Segment net sales decreased 7.2% to \$45,290,000 and Graphics Segment net sales decreased 56.0% to \$15,497,000 as compared to the prior year. Sales to the petroleum / convenience store market represented 22% and 34% of net sales in the second quarters of fiscal years 2009 and 2008, respectively. Net sales to this, the Company's largest niche market, are reported in both the Lighting and Graphics Segments, depending upon the product or service sold, and were down 53% from last year to \$13,484,000 as Lighting sales decreased 11% and Graphics sales to this market decreased 70%. Net sales of products and services related to solid state LED technology in light fixtures and video screens for sports, advertising and entertainment markets totaled \$2.0 million in the three month period ended December 31, 2008, representing approximately a 2% decrease from the same period last year. In addition, the Company sells certain elements of graphic identification programs that contain solid state LED light sources. The petroleum / convenience store market has been, and will continue to be, a very important niche market for the Company; however, if sales to other markets and customers increase more than net sales to this market, then the percentage of net sales to the petroleum / convenience store market would be expected to decline. See Note -3 to these financial statements on Major Customer Concentrations.

The \$3.5 million or 7.2% decrease in Lighting Segment net sales is primarily the result of a \$0.7 million or 2.7% decrease in commissioned net sales to the commercial / industrial lighting market, and a \$3.2 million net decrease in lighting sales to our niche markets of petroleum / convenience stores, automotive dealerships, and national retail accounts.

The \$19.8 million or 56.0% decrease in Graphics Segment net sales is primarily the result of completion of programs for certain graphics customers, including an image conversion program for a national drug store retailer (\$1.9 million decrease), two petroleum / convenience store programs (\$13.4 million decrease), a menu board replacement program (\$4.7 million decrease), sales of solid state LED video screens for the sports markets (\$1.4 million decrease) and changes in volume or completion of other graphics programs. These decreases were partially offset by increased net sales to certain other customers, including a reimaging program for a grocery customer (\$3.6 million), and sales of solid state LED video screens for the entertainment market (\$0.7 million increase).

Image and brand programs, whether full conversions or enhancements, are important to the Company's strategic direction. Image programs include situations where our customers refurbish their retail sites around the country by replacing some or all of the lighting, graphic elements, menu board systems and possibly other items they may source from other suppliers. These image programs often take several quarters to complete and involve both our customers' corporate-owned sites as well as their franchisee-owned sites, the latter of which involve separate sales efforts by the Company with each franchisee. The Company may not always be able to replace net sales immediately

when a large image conversion program has concluded. Brand programs typically occur as new products are offered or new departments are created within an existing retail store. Relative to net sales to a customer before and after an image or brand program, net sales during the program are typically significantly higher, depending upon how much of the lighting or graphics business is awarded to the Company. Sales related to a customer's image or brand program are reported in either the Lighting Segment and/or the Graphics Segment, depending upon the product and/or service provided.

Gross profit of \$13,257,000 in the second quarter of fiscal 2009 decreased 43% from the same period last year, and decreased from 27.9% to 21.8% as a percentage of net sales. The decrease in amount of gross profit is due both to decreased Graphics net sales and margins, both product and installation, as well as decreased gross profit margin on decreased Lighting net sales. The following items also influenced the Company's gross profit margin on a consolidated basis: competitive pricing pressures, increased cost of materials in the Lighting Segment, decreased direct labor reflective of less sales volume, and other manufacturing expenses in support of production requirements (\$0.3 million of increased wage, compensation and benefits costs; \$0.3 million decreased supplies; \$0.2 million of decreased depreciation; and \$0.1 million decreased repairs and maintenance).

Selling and administrative expenses of \$14,014,000 in the second quarter of fiscal year 2009 decreased \$1.7 million, and increased to 23.1% as a percentage of net sales from 18.7% in the same period last year. Employee compensation and benefits expense decreased \$0.1 million in the second quarter of fiscal 2009 as compared to the same period last year. Other changes of expense between years include decreased sales commission expense (\$1.0 million), decreased warranty expense (\$0.3 million), decreased outside services expense (\$0.3 million), increased research & development expense (\$0.2 million, primarily associated with research and development spending related to solid-state LED technology), decreased legal fees (\$0.2 million), increased menu board litigation settlement costs (\$0.2 million), increased bad debt expense (\$0.2 million), decreased intangible asset amortization expense (\$0.1 million) and decreased advertising and literature (\$0.1 million).

The Company recorded an estimated impairment of goodwill in two reporting units in the second quarter of fiscal 2009, and accordingly recorded a non-cash expense in the amount of \$12,669,000 with no similar impairment expense in the second quarter of the prior year. The impairment was related to a decline in the market value of the Company's stock as well as a decline in the estimated forecasted discounted cash flows expected by the Company.

The Company reported net interest income of \$1,000 in the second quarter of fiscal 2009 as compared to net interest income of \$80,000 in the same period last year. The Company was in a positive cash position and was debt free for substantially all of fiscal 2008 and generated interest income on invested cash. The Company was occasionally in a borrowing position the second quarter of fiscal 2009.

The effective tax rate in the second quarter of fiscal 2008 was 38.1%, resulting in an income tax expense of \$2,966,000. The \$363,000 tax credit provision in the second quarter of fiscal 2009 reflects a credit provision of \$531,000 related to the operations of the Company (which includes a \$333,000 release of a FIN 48 income tax liability associated with a voluntary disclosure program) and a tax provision of \$168,000 associated with the impairment of goodwill.

The Company reported a net loss of \$(13,062,000) in the second quarter of fiscal 2009 as compared to net income of \$4,823,000 in the same period last year. The decrease is primarily the result of decreased gross profit on decreased net sales, a \$12.7 million pre-tax goodwill impairment, partially offset by decreased operating expenses and decreased income tax expense. The diluted loss per share was \$(0.60) in the second quarter of fiscal 2009, as compared to earnings per share of \$0.22 in the same period last year. The weighted average common shares outstanding for purposes of computing diluted earnings (loss) per share in the second quarter of fiscal 2009 were 21,799,000 shares as

compared to 22,063,000 shares for the same period last year.

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SIX MONTHS ENDED DECEMBER 31, 2008 COMPARED TO SIX MONTHS ENDED DECEMBER 31, 2007

Net sales of \$136,625,000 in the first half of fiscal 2009 decreased 21.5% from fiscal 2008 first half net sales of \$174,063,000. Lighting Segment net sales decreased 0.7% to \$96,050,000 and Graphics Segment net sales decreased 47.5% to \$40,575,000 as compared to the prior year. Sales to the petroleum / convenience store market represented 21% and 32% of net sales in the first half of fiscal years 2009 and 2008, respectively. Net sales to this, the Company's largest niche market, are reported in both the Lighting and Graphics Segments, depending upon the product or service sold, and were down 49% from last year to \$28,683,000 as Lighting sales were level and Graphics sales to this market decreased 68%. Net sales of products and services related to solid state LED technology in light fixtures and video screens for sports, advertising and entertainment markets totaled \$10.8 million in the six month period ended December 31, 2008, representing approximately a 137% increase from the same period last year. In addition, the Company sells certain elements of graphic identification programs that contain solid state LED light sources. The petroleum / convenience store market has been, and will continue to be, a very important niche market for the Company; however, if sales to other markets and customers increase more than net sales to this market, then the percentage of net sales to the petroleum / convenience store market would be expected to decline. See Note -3 to these financial statements on Major Customer Concentrations.

The \$0.7 million or 0.7% decrease in Lighting Segment net sales is the net result of a \$3.6 million or 6.6% increase in commissioned net sales to the commercial / industrial lighting market, and a \$4.9 million net decrease in lighting sales to our niche markets of petroleum / convenience stores, automotive dealerships, and national retail accounts.

The \$36.8 million or 47.5% decrease in Graphics Segment net sales is primarily the result of completion of programs for certain graphics customers, including an image conversion program for a national drug store retailer (\$3.7 million decrease), two petroleum / convenience store programs (\$26.2 million decrease), a menu board replacement program (\$15.3 million decrease), and changes in volume or completion of other graphics programs. These decreases were partially offset by increased net sales to certain other customers, including a reimaging program for a grocery customer (\$7.9 million), sales of solid state LED video screens for the sports markets (\$2.2 million increase) and for the entertainment market (\$3.3 million increase).

Image and brand programs, whether full conversions or enhancements, are important to the Company's strategic direction. Image programs include situations where our customers refurbish their retail sites around the country by replacing some or all of the lighting, graphic elements, menu board systems and possibly other items they may source from other suppliers. These image programs often take several quarters to complete and involve both our customers' corporate-owned sites as well as their franchisee-owned sites, the latter of which involve separate sales efforts by the Company with each franchisee. The Company may not always be able to replace net sales immediately when a large image conversion program has concluded. Brand programs typically occur as new products are offered or new departments are created within an existing retail store. Relative to net sales to a customer before and after an image or brand program, net sales during the program are typically significantly higher, depending upon how much of the lighting or graphics business is awarded to the Company. Sales related to a customer's image or brand program are reported in either the Lighting Segment and/or the Graphics Segment, depending upon the product and/or service provided.

Gross profit of \$31,436,000 in the first half of fiscal 2009 decreased 36% from the same period last year, and decreased from 28.3% to 23.0% as a percentage of net sales. The decrease in amount of gross profit is due both to decreased Graphics net sales and margins, both product and installation, as well as decreased gross profit margin on slightly lower Lighting net sales. The following items also influenced the Company's gross profit margin on a consolidated basis: competitive pricing pressures, increased cost of materials in the Lighting Segment, decreased direct labor reflective of less sales volume, and other manufacturing expenses in support of production requirements (\$0.7 million of decreased wage, compensation and benefits costs; \$0.3 million decreased supplies; \$0.3 million of decreased depreciation; \$0.2 million decreased repairs and maintenance; and \$0.1 decreased outside services).

Selling and administrative expenses of \$27,977,000 in the first half of fiscal year 2009 decreased \$2.8 million, and increased to 20.5% as a percentage of net sales from 17.7% in the same period last year. Employee compensation and benefits expense decreased \$0.6 million in the first half of fiscal 2009 as compared to the same period last year. Other changes of expense between years include decreased sales commission expense (\$0.9 million), decreased warranty expense (\$0.7 million), decreased outside services expense (\$0.3 million), increased research & development expense (\$0.3 million, primarily associated with research and development spending related to solid-state LED technology), decreased legal fees (\$0.2 million), increased menu board litigation settlement costs (\$0.2 million), increased bad debt expense (\$0.1 million), decreased intangible asset amortization expense (\$0.1 million), decreased supplies (\$0.1 million) and decreased advertising and literature (\$0.1 million).

The Company recorded an estimated impairment of goodwill in two reporting units in the first half of fiscal 2009, and accordingly recorded a non-cash expense in the amount of \$12,669,000 with no similar impairment expense in the first half of the prior year. The impairment was related to a decline in the market value of the Company's stock as well as a decline in the estimated forecasted discounted cash flows expected by the Company.

The Company reported net interest expense of \$4,000 in the first half of fiscal 2009 as compared to net interest income of \$212,000 in the same period last year. The Company was in a positive cash position and was debt free for substantially all of fiscal 2008 and generated interest income on invested cash. The Company was occasionally in a borrowing position the first half of fiscal 2009.

The effective tax rate in the first half of fiscal 2008 was 36.8%, resulting in an income tax expense of \$6,871,000. The \$1,161,000 income tax expense in the first half of fiscal 2009 reflects a tax expense of \$993,000 related to the operations of the Company (which includes a \$333,000 release of a FIN 48 income tax liability associated with a voluntary disclosure program) and a credit provision of \$168,000 associated with the impairment of goodwill.

The Company reported a net loss of \$(10,375,000) in the first half of fiscal 2009 as compared to net income of \$11,776,000 in the same period last year. The decrease is primarily the result of decreased gross profit on decreased net sales and a fiscal 2009 \$12.7 million pre-tax goodwill impairment expense, partially offset by decreased operating expenses and decreased income tax expense. The diluted loss per share was \$(0.48) in the first half of fiscal 2009, as compared to earnings per share of \$0.53 in the same period last year. The weighted average common shares outstanding for purposes of computing diluted earnings (loss) per share in the first half of fiscal 2009 were 21,798,000 shares as compared to 22,036,000 shares for the same period last year.

Liquidity and Capital Resources

The Company considers its level of cash on hand, its borrowing capacity, its current ratio and working capital levels to be its most important measures of short-term liquidity. For long-term liquidity indicators, the Company believes its ratio of long-term debt to equity and its historical levels of net cash flows from operating activities to be the most important measures.

At December 31, 2008 the Company had working capital of \$73.6 million, compared to \$72.9 million at June 30, 2008. The ratio of current assets to current liabilities was 4.72 to 1 as compared to a ratio of 3.32 to 1 at June 30, 2008. The \$0.7 million increase in working capital from June 30, 2008 to December 31, 2008 was primarily related to decreased accounts payable (\$4.8 million), decreased accrued expenses and customer prepayments (\$6.0 million and \$0.9 million, respectively), increased cash and cash equivalents (\$1.2 million), partially offset by decreased inventory (\$6.6 million), decreased accounts receivable (\$3.6 million), and decreased other current assets (\$2.0 million).

The Company generated \$6.6 million of cash from operating activities in the first half of fiscal 2009 as compared to a generation of \$7.3 million last year. This \$0.7 million decrease in net cash flows from operating activities is primarily the net result of less net income (\$22.2 million unfavorable), a non-cash goodwill impairment charge in fiscal 2009 (\$12.7 million favorable), less of a reduction in accounts receivable (unfavorable change of \$9.5 million), a decrease in inventories rather than an increase (favorable change of \$7.6 million), less of a reduction in customer prepayments (favorable change of \$10.5 million), reserve for uncertain income tax positions (unfavorable \$0.2 million), a smaller decrease in accounts payable and accrued expenses (favorable change of \$0.1 million), decreased depreciation and amortization (unfavorable \$0.5 million), larger increases in the reserves for bad debts and inventory obsolescence (favorable \$0.2 million) and an increase in deferred income tax assets rather than a decrease (unfavorable \$0.3 million). The fiscal 2008 significant reduction in customer prepayments is related to the completion of a menu board replacement program in the Graphics Segment.

Net accounts receivable were \$35.2 million and \$38.9 million at December 31, 2008 and June 30, 2008, respectively. The decrease of \$3.7 million in net receivables is primarily due to a larger amount of net sales in the fourth quarter of fiscal 2008 as compared to the second quarter of fiscal 2009, plus the affect of increased DSO (Days' Sales Outstanding). The DSO increased from 54 days at June 30, 2008 to 63 days at December 31, 2008. The Company believes that its receivables are ultimately collectible or recoverable, net of certain reserves, and that aggregate allowances for doubtful accounts are adequate.

Inventories at December 31, 2008 decreased \$6.6 million from June 30, 2008 levels. Primarily in response to customer programs and the timing of shipments, inventory decreases occurred in the Lighting Segment of approximately \$1.2 million (some of this inventory supports certain graphics programs) and in the Graphics Segment of approximately \$5.4 million since June 30, 2008.

Cash generated from operations and borrowing capacity under two line of credit facilities are the Company's primary source of liquidity. The Company has an unsecured \$50 million revolving line of credit with its bank group, with all \$50 million of the credit line available as of January 22, 2009. This line of credit consists of a \$30 million three year committed credit facility expiring in the third quarter of fiscal 2011 and a \$20 million credit facility expiring in the third quarter of fiscal 2009. Additionally, the Company has a separate \$7 million line of credit, renewable annually in the third fiscal quarter, for the working capital needs of its Canadian subsidiary, LSI Saco Technologies. As of January 22, 2009, all \$7 million of this line of credit is available. As both of these lines of credit renew in the third quarter of fiscal 2009, the Company

believes that the combined \$57 million of credit facilities will be extended to the Company by its banks, however, at a higher interest rate due to conditions in the financial markets. The Company believes that the total of available lines of credit plus cash flows from operating activities is adequate for the Company's fiscal 2009 operational and capital expenditure needs. The Company is in compliance with all of its loan covenants.

The Company used \$0.9 million of cash related to investing activities in the first half of fiscal 2009 as compared to a generation of \$5.5 million last year. The primary change between years relates to the fiscal 2008 divestiture of short-term investments (\$8.0 million unfavorable) and decreased purchase of fixed assets (\$1.7 million favorable). Capital expenditures of \$0.9 million in the first half of fiscal 2009 compared to \$2.5 million in the same period last year. Spending in both periods is primarily for tooling and equipment. The Company expects fiscal 2009 capital expenditures to approximate \$3 million, exclusive of business acquisitions.

The Company used \$4.5 million of cash related to financing activities in the first half of fiscal 2009 as compared to a use of \$6.4 million in the same period last year. The \$1.9 million change between periods is primarily the result of lower cash dividend payments (\$4,314,000 in the first half of fiscal 2009 as compared to \$7,107,000 in the same period last year). The \$2.8 million reduction in dividend payments between years is primarily the net result of a special year-end dividend of approximately \$1.1 million paid in the first quarter of fiscal 2008 with none in fiscal 2009, and a lower per share dividend rate beginning in the second quarter of fiscal 2009. Additionally, the Company had cash flow from the exercise of stock options in the first half of fiscal 2008, while there were no exercises in the first half of fiscal 2009 (\$0.8 million unfavorable).

The Company has financial instruments consisting primarily of cash and cash equivalents and short-term investments, revolving lines of credit, and long-term debt. The fair value of these financial instruments approximates carrying value because of their short-term maturity and/or variable, market-driven interest rates. The Company has no financial instruments with off-balance sheet risk and has no off balance sheet arrangements.

On January 21, 2009 the Board of Directors declared a regular quarterly cash dividend of \$0.05 per share (approximately \$1,079,000) payable February 10, 2009 to shareholders of record on February 3, 2009. The Company's cash dividend policy is that the indicated annual dividend rate will be set between 50% and 70% of the expected net income for the current fiscal year. Consideration will also be given by the Board to special year-end cash or stock dividends. The declaration and amount of any cash and stock dividends will be determined by the Company's Board of Directors, in its discretion, based upon its evaluation of earnings, cash flow, capital requirements and future business developments and opportunities, including acquisitions. Accordingly, the Board established a new indicated annual cash dividend rate of \$0.20 per share beginning with the first quarter of fiscal 2009 consistent with the above dividend policy.

Carefully selected acquisitions have long been an important part of the Company's strategic growth plans. The Company continues to seek out, screen and evaluate potential acquisitions that could add to the Lighting or Graphics product lines or enhance the Company's position in selected markets. The Company believes adequate financing for any such investments or acquisitions will be available through future borrowings or through the issuance of common or preferred shares in payment for acquired businesses. Pursuant to a non-binding letter of intent, the Company had been involved in discussions to acquire a small producer of specialty lighting products. However, a mutually acceptable agreement was not able to be reached and all discussions have been terminated.

Critical Accounting Policies and Estimates

The Company is required to make estimates and judgments in the preparation of its financial statements that affect the reported amounts of assets, liabilities, revenues and expenses, and related footnote disclosures. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. The Company continually reviews these estimates and their underlying assumptions to ensure they remain appropriate. The Company believes the items discussed below are among its most significant accounting policies because they utilize estimates about the effect of matters that are inherently uncertain and therefore are based on management's judgment. Significant changes in the estimates or assumptions related to any of the following critical accounting policies could possibly have a material impact on the financial statements.

Revenue Recognition

The Company recognizes revenue in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 104, "Revenue Recognition." Revenue is recognized when title to goods and risk of loss have passed to the customer, there is persuasive evidence of a purchase arrangement, delivery has occurred or services have been rendered, and collectibility is reasonably assured. Revenue is typically recognized at time of shipment. Sales are recorded net of estimated returns, rebates and discounts. Amounts received from customers prior to the recognition of revenue are accounted for as customer prepayments and are included in accrued expenses. Revenue is recognized in accordance with EITF 00-21 or AICPA Statement of Position 97-2 (SOP 97-2), "Software Revenue Recognition," as appropriate.

The Company has four sources of revenue: revenue from product sales; revenue from installation of products; service revenue generated from providing integrated design, project and construction management, site engineering and site permitting; and revenue from shipping and handling. Product revenue is recognized on product-only orders at the time of shipment. Product revenue related to orders where the customer requires the Company to install the product is generally recognized when the product is installed. In some situations, product revenue is recognized when the product is shipped, before it is installed, because by agreement the customer has taken title to and risk of ownership for the product before installation has been completed. Other than normal product warranties or the possibility of installation or post-shipment service, support and maintenance of certain solid state LED video screens, billboards, or active digital signage, the Company has no post-shipment responsibilities. Installation revenue is recognized when the products have been fully installed. The Company is not always responsible for installation of products it sells and has no post-installation responsibilities, other than normal warranties. Service revenue from integrated design, project and construction management, and site permitting is recognized at the completion of the contract with the customer. With larger customer contracts involving multiple sites, the customer may require progress billings for completion of identifiable, time-phased elements of the work, in which case revenue is recognized at the time of the progress billing which coincides with the completion of the earnings process. Post-shipment service and maintenance revenue, if applicable, related to solid state LED video screens or billboards is recognized according to terms defined in each individual service agreement and in accordance with generally accepted accounting principles. Shipping and handling revenue coincides with the recognition of revenue from sale of the product.

Income Taxes

The Company accounts for income taxes in accordance with Statement of Financial Accounting Standards (SFAS) No. 109, "Accounting for Income Taxes;" accordingly, deferred income taxes are provided on items that are reported as either income or expense in different time periods for financial reporting purposes than they are for income tax purposes. Deferred income tax assets and liabilities are reported on the Company's balance sheet. Significant management judgment is required in developing the Company's income tax provision, including the determination of deferred tax assets and liabilities and any valuation allowances that might be required against deferred tax assets.

The Company operates in multiple taxing jurisdictions and is subject to audit in these jurisdictions. The Internal Revenue Service and other tax authorities routinely review the Company's tax returns. These audits can involve complex issues which may require an extended period of time to resolve. In management's opinion, adequate provision has been made for potential adjustments arising from these examinations.

As of December 31, 2008 the Company has recorded two deferred state income tax assets, one in the amount of \$5,000 related to a state net operating loss carryover generated by the Company's New York subsidiary, and the other in the amount of \$935,000, net of federal tax benefits, related to non-refundable state tax credits. The Company has determined that these deferred state income tax assets totaling \$940,000 do not require any valuation reserves because, in accordance with Statement of Financial Accounting Standards No. 109 (SFAS No. 109), these assets will, more likely than not, be realized. Additionally, as of December 31, 2008 the Company has recorded deferred tax assets for its Canadian subsidiary related to net operating loss carryover and to research and development tax credits totaling \$1,707,000. In view of the impairment of the goodwill and certain intangible assets on the financial statements of this subsidiary and two consecutive loss years, the Company has determined these assets, more likely than not, will not be realized. Accordingly, full valuation reserves of \$1,707,000 have been recorded.

The Company adopted the provisions of FASB Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes," on July 1, 2007. As a result of adoption, the Company recognized \$2,582,000 in reserves for uncertain tax positions and recorded a charge of \$2,582,000 to the July 1, 2007 retained earnings balance. At June 30, 2008, tax and interest, net of potential federal tax benefits, were \$2,098,000 and \$534,000, respectively, of the total reserves of \$3,225,000. Additionally, penalties were \$593,000 of the reserve at June 30, 2008. Of the \$3,225,000 reserve for uncertain tax positions, \$2,632,000 would have an unfavorable impact on the effective tax rate if recognized.

As of December 31, 2008, the Company recognized an additional \$31,000 tax expense related to the increase in reserves for uncertain tax positions. The Company is recording estimated interest and penalties related to potential underpayment of income taxes as a component of tax expense in the Consolidated Statements of Operations. The reserve for uncertain tax positions is not expected to change significantly in the next 12 months.

Equity Compensation

The Company adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), "Share-Based Payment," effective July 1, 2005. SFAS No. 123(R) requires public entities to measure the cost of employee services received in exchange for an award of equity instruments and recognize this cost over the period during which an employee is required to provide the services.

Asset Impairment

Carrying values of goodwill and other intangible assets with indefinite lives are reviewed at least annually for possible impairment in accordance with Statement of Financial Accounting Standards No. 142 (SFAS No. 142), "Goodwill and Other Intangible Assets." The Company's impairment review involves the estimation of the fair value of goodwill and indefinite-lived intangible assets using a combination of a market approach and an income (discounted cash flow) approach, at the reporting unit level, that requires significant management judgment with respect to revenue and expense growth rates, changes in working capital and the selection and use of an appropriate discount rate. The estimates of fair value of reporting units are based on the best information available as of the date of the assessment. The use of different assumptions would increase or decrease estimated discounted future operating cash flows and could increase or decrease an impairment charge. Company management uses its judgment in assessing whether assets may have become impaired between annual impairment tests. Indicators such as adverse business conditions, economic factors and technological change or competitive activities may signal that an asset has become impaired. A \$28,183,000 goodwill impairment charge was recorded as of June 30, 2008 as a result of the Company's annual impairment test. The impairment charge was due primarily to the combination of a decline in the market capitalization of the Company at June 30, 2008 and the decline in the estimated forecasted discounted cash flows expected by the Company. This impairment charge was recorded in the fourth quarter of fiscal 2008 rather than in the first quarter of fiscal 2009 due to the decline in the Company's stock price as of June 30, 2008. Also see Note 7.

Due to current economic conditions, the effects of the recession on the Company's markets and the decline in the Company's stock price, management believed that an additional goodwill impairment test was required as of December 31, 2008. Based upon the Company's preliminary analysis, it was determined that the goodwill associated with the two remaining reporting units that contain goodwill was either fully or partially impaired. The total amount of the estimated goodwill impairment was \$12,669,000, of which \$11,320,000 was full impairment of the goodwill within one reporting unit in the Lighting Segment and \$1,349,000 represents a partial impairment of the goodwill within one reporting unit in the Graphics Segment. The impairment charge was due to a combination of a decline in the market capitalization of the Company at December 31, 2008 and a decline in the estimated forecasted discounted cash flows since the annual goodwill impairment test was performed. The impairment charge was recorded in the second quarter and is considered an estimate, subject to completion of our valuation procedures.

Carrying values for long-lived tangible assets and definite-lived intangible assets, excluding goodwill and indefinite-lived intangible assets, are reviewed for possible impairment as circumstances warrant in connection with Statement of Financial Accounting Standards No. 144 (SFAS No. 144), "Accounting for the Impairment or Disposal of Long-Lived Assets." Impairment reviews are conducted at the judgment of Company management when it believes that a change in circumstances in the business or external factors warrants a review. Circumstances such as the discontinuation of a product or product line, a sudden or consistent decline in the forecast for a product, changes in technology or in the way an asset is being used, a history of negative operating cash flow, or an adverse change in legal factors or in the business climate, among others, may trigger an impairment review. The Company's initial impairment review to determine if a potential impairment charge is required is based on an undiscounted cash flow analysis at the lowest level for which identifiable cash flows exist. The analysis requires judgment with respect to changes in technology, the continued success of product lines and future volume, revenue and expense growth rates, and discount rates. As a result of the fiscal year 2008 review of long lived assets and definite-lived intangible assets in connection with SFAS No. 144, it was determined that a certain trade name within the Lighting Segment was deemed fully impaired because it was no longer used in the Company's marketing efforts. An impairment charge of \$746,000 was recorded as of June 30, 2008. There were no impairment charges related to long-lived tangible assets or definite-lived intangible assets recorded by the Company during the first quarter of fiscal year 2009.

Credit and Collections

The Company maintains allowances for doubtful accounts receivable for probable estimated losses resulting from either customer disputes or the inability of its customers to make required payments. If the financial condition of the Company's customers were to deteriorate, resulting in their inability to make the required payments, the Company may be required to record additional allowances or charges against income. The Company determines its allowance for doubtful accounts by first considering all known collectibility problems of customers' accounts, and then applying certain percentages against the various aging categories of the remaining receivables. The resulting allowance for doubtful accounts receivable is an estimate based upon the Company's knowledge of its business and customer base, and historical trends. The Company also establishes allowances, at the time revenue is recognized, for returns and allowances, discounts, pricing and other possible customer deductions. These allowances are based upon historical trends.

New Accounting Pronouncements

In July 2006, the Financial Accounting Standards Board issued FASB Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109." FIN 48 provides guidance for the recognition, measurement, classification and disclosure of the financial statement effects of a position taken or expected to be taken in a tax return ("tax position"). The financial statement effects of a tax position must be recognized when there is a likelihood of more than 50 percent that based on the technical merits, the position will be sustained upon examination and resolution of the related appeals or litigation processes, if any. A tax position that meets the recognition threshold must be measured initially and subsequently as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement with a taxing authority. In addition, FIN 48 specifies certain annual disclosures that are required to be made once the interpretation has taken effect. The Interpretation was effective for fiscal years beginning after December 15, 2006. The Company adopted the provisions of FIN 48 on July 1, 2007. As a result of adoption, the Company recognized a \$2,582,000 increase to reserves for uncertain tax positions and recorded a charge of \$2,582,000 to the July 1, 2007 retained earnings balance. For additional information, see Note 9 to the Consolidated Financial Statements.

In September 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 157, "Fair Value Measurements." This Statement provides a new definition of fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. The Statement applies under other accounting pronouncements that require or permit fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007, or the Company's fiscal year 2009. Two FASB Staff Positions (FSP) were subsequently issued. In February 2007, FSP No. 157-2 delayed the effective date of this SFAS No. 157 for non-financial assets and non-financial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis. This FSP is effective for fiscal years beginning after November 15, 2008, or the Company's fiscal year 2010. FSP No. 157-1, also issued in February 2007, excluded FASB No. 13 "Accounting for Leases" and other accounting pronouncements that address fair value measurements for purposes of lease classification or measurement under FASB No. 13. However, this scope exception does not apply to assets acquired and liabilities assumed in a business combination that are required to be measured at fair value under FASB Statement No. 141, "Business Combinations" or FASB No. 141R, "Business Combinations." This FSP is

effective upon initial adoption of SFAS No. 157. The Company adopted SFAS No. 157 on July 1, 2008, and the adoption did not have any significant impact on its consolidated results of operations, cash flows or financial position. The Company determined that it does not have any financial assets or liabilities subject to the disclosure requirements of SFAS No. 157, and is evaluating the disclosure impact on its non-financial assets and liabilities.

In February 2007, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities." This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The election is made on an instrument-by-instrument basis and is irrevocable. If the fair value option is elected for an instrument, SFAS No. 159 specifies that all subsequent changes in fair value for that instrument shall be reported in earnings. The objective of the pronouncement is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007, or in the Company's case, July 1, 2008. The Company has not made any fair value elections under SFAS No. 159 and did not have any impact on its consolidated results of operations, cash flows or financial position.

In December 2007, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 141 (revised 2007), "Business Combinations," which replaces SFAS No. 141. The statement retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It also changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition related costs as incurred. SFAS No. 141R is effective for us beginning July 1, 2009 and will apply prospectively to business combinations completed on or after that date.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes in the Registrant's exposure to market risk since June 30, 2008. Additional information can be found in Item 7A, Quantitative and Qualitative Disclosures About Market Risk, which appears on page 14 of the Annual Report on Form 10-K for the fiscal year ended June 30, 2008.

ITEM 4. CONTROLS AND PROCEDURES

An evaluation was performed as of December 31, 2008 under the supervision and with the participation of the Registrant's management, including its principal executive officer and principal financial officer, of the effectiveness of the design and operation of the Registrant's disclosure controls and procedures pursuant to Rule 13a-15(b) and 15d-15(b) promulgated under the Securities Exchange Act of 1934. Based upon this evaluation, the Registrant's Chief Executive Officer and Chief Financial Officer concluded that the Registrant's disclosure controls and procedures were effective as of December 31, 2008, in all material respects, to ensure that information required to be disclosed in the reports the Registrant files and submits under the Exchange Act are recorded, processed, summarized and reported as and when required.

There have been no changes in the Registrant's internal control over financial reporting that occurred during the most recently ended fiscal period of the Registrant or in other factors that have materially affected or are reasonably likely to materially affect the Registrant's internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1A. RISK FACTORS

Other than with respect to the new risk factor below, there have been no material changes from the risk factors previously disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended June 30, 2008.

Our operating results may be adversely affected by unfavorable economic and market conditions.

Economic conditions worldwide have from time to time contributed to slowdowns in our industry at large, as well as to the specific segments and markets in which we operate. When combined with ongoing customer consolidation activity and periodic manufacturing and inventory initiatives, the current uncertain macro-economic climate, including but not limited to the effects of weakness in credit markets, could lead to reduced demand from our customers and increased price competition for our products, increased risk of excess and obsolete inventories and higher overhead costs as a percentage of revenue. If the markets in which we participate experience further economic downturns, as well as a slow recovery period, this could negatively impact our sales and revenue generation, margins and operating expenses, and consequently have a material adverse effect on our business, financial condition and results of operations.

In addition, we have significant goodwill and intangible assets recorded on our balance sheet. We will continue to evaluate the recoverability of the carrying amount of our goodwill and intangible assets on an ongoing basis, and we may incur substantial non-cash impairment charges, which would adversely affect our financial results. There can be no assurance that the outcome of such reviews in the future will not result in substantial impairment charges. Impairment assessment inherently involves judgment as to assumptions about expected future cash flows and the impact of market conditions on those assumptions. Future events and changing market conditions may impact our assumptions as to prices, costs, holding periods or other factors that may result in changes in our estimates of future cash flows. Although we believe the assumptions we used in testing for impairment are reasonable, significant changes in any one of our assumptions could produce a significantly different result.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

- (c) The Company does not purchase into treasury its own common shares for general purposes. However, the Company does purchase its own common shares, through a Rabbi Trust, in connection with investments of employee/participants of the LSI Industries Inc. Non-Qualified Deferred Compensation Plan. Purchases of Company common shares for this Plan in the second quarter of fiscal 2009 were as follows:

ISSUER PURCHASES OF EQUITY SECURITIES

| Period | (a) Total Number of Shares Purchased | (b) Average Price Paid per Share | (c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | (d) Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs |
|---------------------|--------------------------------------|----------------------------------|--|--|
| 10/1/08 to 10/31/08 | 725 | \$ 6.51 | 725 | (1) |
| 11/1/08 to 11/30/08 | 841 | \$ 6.18 | 841 | (1) |
| 12/1/08 to 12/31/08 | -- | -- | -- | (1) |
| Total | 1,566 | \$ 6.33 | 1,566 | (1) |

(1) All acquisitions of shares reflected above have been made in connection with the Company's Non-Qualified Deferred Compensation Plan, which has been authorized for 375,000 shares of the Company to be held in the Plan. At December 31, 2008, the Plan held 229,199 shares of the Company.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

At the Company's Annual Meeting of Shareholders held November 20, 2008, the following actions were taken by shareholders:

4.1 All persons nominated as Directors were elected with the votes for each person being:

| Name | Shares For | Shares – Withheld Authority | Shares Abstained | Broker Non-Votes |
|-------------------|-------------------|-----------------------------|------------------|------------------|
| Gary P. Kreider | 10,498,144.450483 | 9,704,764.657053 | N/A | none |
| Dennis B. Meyer | 19,887,554.450483 | 315,354.657053 | N/A | none |
| Wilfred T. O'Gara | 19,887,554.450483 | 305,408.657053 | N/A | none |
| Robert J. Ready | 13,355,964.887911 | 6,846,944.219625 | N/A | none |
| Mark A. Serriane | 19,897,025.107536 | 305,884.000 | N/A | none |
| James P. Sferra | 12,511,947.107536 | 7,690,962.000 | N/A | none |

4.2 Ratification of the appointment of Deloitte & Touche LLP as independent registered public accounting firm for fiscal 2009.

| Shares For | Shares Against | Shares Abstained | Broker Non-Votes |
|-------------------|----------------|------------------|------------------|
| 20,081,936.343744 | 78,561 | 42,411.763792 | none |

4.3 Amendment of the Company's Code of Regulations

| Shares For | Shares Against | Shares Abstained | Broker Non-Votes |
|-------------------|------------------|------------------|------------------|
| 18,904,654.481843 | 1,201,196.373202 | 97,058.252491 | none |

ITEM 6. EXHIBITS

- a) Exhibits
- 31.1 Certification of Principal Executive Officer required by Rule 13a-14(a)
- 31.2 Certification of Principal Financial Officer required by Rule 13a-14(a)
- 32.1 Section 1350 Certification of Principal Executive Officer
- 32.2 Section 1350 Certification of Principal Financial Officer

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

LSI Industries Inc.

By: /s/Robert J. Ready
Robert J. Ready
President and Chief Executive Officer
(Principal Executive Officer)

By: /s/Ronald S. Stowell
Roald S. Stowell
Vice President, Chief Financial Officer
and Treasurer
(Principal Financial and Accounting
Officer)

January 30, 2009